In the

Supreme Court of the United States

October Term, 1965

No. 23

FRIBOURG NAVIGATION COMPANY, INC.,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

REPLY BRIEF FOR THE PETITIONER

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I. The Commissioner Has Failed to Reconcile the Treatment of Sales at a Loss with His Position in this Case.

The established rules relating to sales of depreciable property at a loss completely undermine the Commissioner's position. Yet the Commissioner cannot reconcile—and in his brief he has not attempted to reconcile—the treatment of losses with his position in this case.

The Commissioner says that estimated useful life and salvage value are mere temporary expedients that must yield to the actual period of use and sales price when the latter become known (Resp. Br. 5, 16, 18-19). The Commissioner arbitrarily assumes that "depreciation is intended to give the taxpayer deductions which are, in total, as nearly equal to the actual net cost [which he defines as cost less actual sales price] of the asset being depreciated as possible" (Resp. Br. 19; *id.*, 5, 12), and he concludes that deprecia-

tion for the year of sale should be revised to achieve this objective (*id.*, 6, 7, 15, 16).

If the Commissioner's line of reasoning were correct, it would have to apply to sales of depreciable property at a loss as well as to sales at a gain. If the "real salvage price" replaces the "false assumption" and fixes "actual net cost" (Resp. Br. 22-23), it does so regardless of whether it exceeds or is less than adjusted basis at the beginning of the year of sale. If depreciation for the year of sale is to be conformed to "actual net cost," the depreciation deduction for the year of sale at a loss must be increased by the amount of that loss. As a result, what has always been regarded as a loss on the sale of depreciable property would instead be deductible as additional depreciation for the year of sale.[1]

The Commissioner's "actual net cost" theory would thus render meaningless the elaborate structure of income tax provisions requiring losses on sale of depreciable property to be offset against amounts otherwise reportable as capital gain; to be treated as capital losses where the property was income-producing but not a business asset; or, under various circumstances, to be totally nonrecognized (Pet. Br. 39). Similarly, the long history of Congressional struggle with the tax treatment of losses from sales of depreciable property in the Revenue Acts of 1921, 1938 and 1942 (Pet. Br. 32-34) would have been devoted to a nonexistent problem.

We discussed this point in our earlier brief (Pet. Br. 39-40), but the Commissioner's brief is silent on it. He has no answer to the refutation of his position by the rules relating to sales of depreciable property at a loss.

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[1]Even if inadequate depreciation had been taken for previous years, loss on sale would still be eliminated, for the basis of depreciable property must be reduced for allowable depreciation even though a lesser amount has been allowed. Int. Rev. Code of 1954, § 1016(a)(2). This adjustment affects both the basis for determining gain or loss and the basis for depreciation. Int. Rev. Code of 1954, §§ 167(g) and 1011. As a result, the basis for depreciation can never be less than the adjusted basis for determining loss.

II. The Commissioner Errs in Asserting That There Is No Long-Standing Administrative Practice Contrary to His Position.

The Commissioner disagrees with our argument that his position in this case is contrary to more than four decades of administrative practice allowing depreciation for the year of profitable sale (Resp. Br. 34, 44). He attempts to date his present position back at least to 1942. However, his attempt is plainly refuted by the sudden emergence of hundreds of court cases contesting disallowance of year-of-sale depreciation. This case—the most advanced of the lot—was docketed in the Tax Court late in 1960. More than 300 such cases are now in litigation.[2] There is only one explanation for the heavy current case load involving this issue when there was none five years ago: the Commissioner suddenly reversed his position.

We cited in our earlier brief, as proof of the Commissioner's long administrative practice of allowing year-of-sale depreciation, twenty-four court cases reflecting such administrative allowances (Pet. Br. 19-21), four published rulings (*id.*, 21), the Commissioner's successful demand that the depreciation be taken even though it produced no tax benefit (*id.*, 23), his acquiescence in a Tax Court decision allowing such depreciation (*id.*, 25), provisions of the income tax regulations (*id.*, 25-27), and the Commissioner's disavowal on brief in the *Cohn* and *Massey* cases of the position he urges here (*id.*, 43-45, 47-48). We had supposed that further proof would be merely cumulative, but since the Commissioner, to our surprise, denies the ad-

[2] This figure was recently obtained informally from the Internal Revenue Service. The Government's petition for certiorari in *United States* v. *S & A Co.*, No. 50, this Term, p. 5, states that 178 such cases were in litigation as of September 1964.

ministrative practice, additional citations may refresh his recollection:

(a) In *Crane* v. *Commissioner,* 331 U. S. 1 (1947), the Commissioner allowed the $3,200 of depreciation claimed by the taxpayer for the year of profitable sale of a building. *Beulah B. Crane,* 3 T. C. 585, 587 (1944). This Court sustained the Commissioner's determination of gain based upon allowance of such depreciation.

(b) In S. M. 2112, III-2 C. B. 22 (1924), the Commissioner held that in computing gain on sale of a leasehold in May, 1919, the basis of the leasehold had to be reduced "because of the exhaustion of the lease due to the lapse of time. . . . [A]t the date of the sale, a large part of the property value as of March 1, 1913, had ceased to exist. The true gain or loss from the sale of property can not be arrived at except through a comparison of the basic price and the sale price of the same property. To compare the basic price of the entire property with the sale price of only a part of the property clearly does not give the true gain or loss."

(c) In *C. B. Shaffer,* 29 B. T. A. 1315 (1934), a partnership had failed to claim depreciation on its oil refinery and producing equipment for the period January 1, 1919 to the date of its profitable sale on May 31, 1919. However, said the Board, "The respondent admits that the partnership is entitled to depreciation for the period." 29 B. T. A. at 1324. The Board then proceeded to fix the rates of depreciation for that period.

(d) In each of the following additional cases the Commissioner allowed depreciation for the year of profitable sale: *F. A. Gillespie & Sons Co.* v. *Commissioner,* 154 F. 2d 913, 915 (10th Cir. 1946); *Seymour Mfg. Co.* v. *Burnet,* 56 F. 2d 494, 495-496 (D. C. Cir.

1932); *M. Hilty Lumber Co.* v. *United States,* 3 F. Supp. 657 (Ct. Cl. 1933); *Gunnison Sugar Co.* v. *Hinckley,* 32 A. F. T. R. 1666, 1668 (D. Utah 1942), *rev'd,* 139 F. 2d 492 (10th Cir. 1943); *George Blodgett Co.* v. *Ham,* 16 A. F. T. R. 1003 (D. Me. 1934); *United States* v. *Farrell,* 35 F. 2d 38, 39 (D. Conn. 1929); *Nocona Cotton Seed Oil Co.,* 42 B. T. A. 1172, 1175, 1178 (1940); *Emily N. Vanderpoel Trust,* 3 B. T. A. 372, 374 (1926); *William Ziegler, Jr.,* 1 B. T. A. 186, 192 (1924); *H. L. Gatlin,* T. C. Memo. 1960-23, 19 CCH T. C. Memo. 131, 132 (1960); *P. H. & J. M. Brown Co.,* T. C. Memo. 1959-162, 18 CCH T. C. Memo. 708, 709 (1959); *Elizabeth Operating Corp.,* T. C. Memo. 112709, 2 CCH T. C. Memo. 817, 818 (1943).

(e) The income tax statute provides a "reasonable allowance" for depletion as well as for depreciation.[8] As this Court has recognized, the common purpose of both these allowances is to permit the tax-free return of capital through writeoff of wasting assets. *Parsons* v. *Smith,* 359 U. S. 215, 220 (1959); *Anderson* v. *Helvering,* 310 U. S. 404, 408 (1940). The Commissioner's consistent practice over the years has been to allow depletion as well as depreciation for the year of profitable sale. *United States* v. *Ludey,* 274 U. S. 295 (1927); *Eldorado Coal & Mining Co.* v. *Mager,* 255 U. S. 522 (1921); *F. A. Gillespie & Sons Co.* v. *Commissioner, supra; M. Hilty Lumber Co.* v. *United States, supra; C. E. Wentz, Trustee,* 26 B. T. A. 868, 869 (1932); *Barnett Anchor Oil Co.,* 25 B. T. A. 746, 749 (1932).

To present in convenient form the Commissioner's practice, we show, in an Appendix hereto, for 36 of the court

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[8]*Compare* Int. Rev. Code of 1954, § 611(a) *with id.,* § 167(a).

decisions and rulings cited above and in our earlier brief, the date of profitable sale, the type of property sold, whether gain on the sale qualified for the favorable capital gains rate,[4] and the allowance of depreciation or depletion made for the year of sale. These decisions and rulings demonstrate beyond doubt that from the advent of the income tax until 1960, the Commissioner interpreted and administered the depreciation statute by allowing depreciation for the year of profitable sale on the basis of the reasonable estimates of useful life and salvage value employed for prior years.

The Commissioner attempts to dismiss the rulings and cases on which we rely because they dealt with tax years before 1922, when sales of depreciable property first became eligible for capital gain treatment (Resp. Br. 34-35). However, twenty-one of the cases and rulings summarized in the Appendix involved sales made after 1921; and eight of such 21 cases involved gains that clearly qualified for the favorable capital gains rate. From 1913 until 1960 (a period of 47 years during 34 of which depreciable property was eligible for capital gain) there were only two cases[5] in which taxpayers challenged disallowance of reasonable estimated depreciation for the year of profitable sale—and in both cases the Tax Court held the depreciation was allowable (Pet. Br. 22, 23-24). The lack of any other litigation of that issue, which must have been presented in hundreds

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[4]Some of the gains realized during 1922-1937 or after 1941 failed to qualify for the favorable capital gains rate for lack of sufficient holding period or for other reasons.

[5]*Duncan-Homer Realty Co.*, 6 B. T. A. 730 (1927), and the automobile issue in *Wier Long Leaf Lumber Co.*, 9 T. C. 990 (1947), *aff'd and rev'd on other issues*, 173 F. 2d 549 (5th Cir. 1949). The *Cohn* decision in 1958 did not involve the issue (Pet. Br. 43-45). Isolated instances of inconsistency such as are represented by these two attempted disallowances "can be found in most areas where the volume of cases is as large as it is here." *Massey Motors, Inc.* v. *United States*, 364 U. S. 92, 103, note 5 (1960).

of returns every year, speaks for itself as to the extraordinary degree of administrative consistency in allowing depreciation for the year of profitable sale.

The course of administrative practice since 1942 also speaks for itself. The last eight cases listed in the Appendix were decided after 1942, and the last five involved years affected by the 1942 capital gain legislation. The acquiescence in the automobile issue in the *Wier* case was outstanding from 1948 until 1962 (Pet. Br. 25, 40). The example in the income tax regulations of allowance of depreciation for the year of profitable sale was outstanding from 1951 until 1965 (Pet. Br. 26, 40). The Government's briefs in the *Cohn* and *Massey* cases, written in 1958-1960, disavowed the existence of the practice the Commissioner now seeks to date back to 1942.[6] The current depreciation regulations, issued in 1956, are out of harmony with that practice (Pet. Br. 25-26). As we have noted, the hundreds of pending cases protesting that practice did not begin accumulating until 1960.[7]

The Commissioner also attempts to disparage the early rulings and court decisions on the ground that they were not "focused on the issue presented here" because they were "occupied with establishing the basic ground rules for computing depreciation and determining the amount of gain on sale"[8] (Resp. Br. 36, 37). However, this case involves a basic ground rule for computing depreciation and gain on

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[6]See p. 3, *supra*.

[7]See p. 3, *supra*.

[8]The Commissioner also erroneously suggests that two of the published rulings requiring depreciation to date of sale—G. C. M. 1597, VI-1 C. B. 71 (1927) and I. T. 1494, I-2 C. B. 19 (1922)—did not clearly involve gain on sale (Resp. Br. 35-36). However, G. C. M. 1497 expressly states that "the question has arisen as to the adjustment for depreciation in determining the profit from the transaction" (VI-1 C. B. at 71); and I. T. 1494 found that "there was a gain" and that it was not taxable (I-2 C. B. at 21)—not, as respondent asserts, that no gain existed.

sale. When the great volume of authority contrary to the Commissioner's present position was developed, it was a universally understood ground rule that depreciation was allowable up to the date of sale. Furthermore, we are unaware of any doctrine that a long-continued and consistent administrative practice, published rulings, court decisions acquiescences, Congressional committee reports, and Treasury regulations should be disregarded because the Commissioner thinks he "failed to focus upon the issue" (Resp Br. 35).

Moreover, the authorities in question do not suffer from the alleged lack of focus. The issue was squarely presented and squarely adjudicated in the *Simons* case and with respect to the automobiles in the *Wier* case (Pet. Br 23-24). The other precedents repeatedly showed a ful awareness of the issue and a keen perception of depreciation principles. For example: (a) This Court recognized in *Ludey* the importance of separating "the original cos of the whole" plant into the two elements necessary to a fair determination of depreciation and gain on sale: "the cost of the part" of which "a gradual sale is made" by being used up and "the cost of that disposed of in the final sale." 274 U. S. at 301. (b) The language quoted at p. 4 *supra*, from S. M. 2112 shows an understanding that the cost of a leasehold must also be fairly allocated between the portion used up and the portion that "had ceased to exist" at the time of the final sale. (c) Even earlier the Board of Tax Appeals in *Even Realty Co.,* 1 B. T. A. 35 (1925), had clearly focused upon the subject:

> "* * * The [Corporation Tax A]ct of 1909 said 'a reasonable allowance for depreciation of property if any.' The Revenue Act of 1913 restricted the deduction to an allowance for depreciation *by use wear, and tear.* And the later revenue acts elimi

> nated the word *depreciation* entirely (see p. 359, *supra*). There is nothing in any of the revenue acts subsequent to the Sixteenth Amendment which would have precluded the taxpayer from taking a reasonable deduction for *wear and tear* upon its building, even though the building itself might have appreciated in value at the same time.
>
> "Depreciation in its broad sense, like appreciation, may be due to extrinsic causes, but that is not true of *wear and tear*. There is no reason why *wear and tear,* purely intrinsic matters, need be tied up to *appreciation* resulting from extrinsic causes. The two can go on simultaneously and no provision of law requires the one to be offset against the other. * * *" 1 B. T. A. at 361. (Emphasis in original.)

Proceeding from the above analysis the Board held, with respect to the taxpayer's profitable sale of an office building during the year 1920, that the cost of the building "should be adjusted by proper allowance for exhaustion, wear and tear and obsolescence from date of acquisition to date of sale, and the adjusted cost subtracted from the sale price to determine the gain upon the sale." 1 B. T. A. at 365.

The Commissioner attempts to disregard as "internally inconsistent" and not "important" the decision against him in the *Wier* case and his prompt acquiescence therein[9] (Resp. Br. 40). However, the stipulation on the automobile issue in the *Wier* case was clearly designed to present squarely the question whether, as a matter of law, the sales price received on a profitable sale of property limits the amount of depreciation allowable for the year of sale.

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[9] *Wier Long Leaf Lumber Co.*, 9 T. C. 990 (1947), *acq.*, 1948-1 C. B. 3 (withdrawn), *nonacq.*, 1962-1 C. B. 5, *aff'd and rev'd on other issues*, 173 F. 2d 549 (5th Cir. 1949), discussed at Pet. Br. 23-25.

The Commissioner's prompt acquiescence in the allowance of year-of-sale depreciation on the automobiles was an acknowledgment that there was no such rule of law (Pet. Br. 25). The disallowance of depreciation on the sawmill is not inconsistent with the decision on the automobile issue, but was a factual holding that petitioner had not "met its burden of proof" as to the proper amount of depreciation on the sawmill, since it introduced "no evidence" of salvage value, 9 T. C. at 998, 999.

The Commissioner errs in asserting that the regulation showing depreciation to be allowable in the year of profitable sale should be given no effect because he was "at the same time judicially attacking the deductibility of such depreciation" (Resp. Br. 42, note 27). This regulation was initially issued in 1951 under the Internal Revenue Code of 1939 as part of Regs. 111, was reissued in 1953 in Regs. 118, and then reissued again in the 1954 Code regulations in 1957.[10] Respondent's decision to attack the deductibility of depreciation in the year of sale did not occur until years later.[11] Furthermore, the regulation was directly drawn from an example in the Congressional committee reports showing depreciation to be allowable in the year of profitable sale.[12]

Respondent's further assertion that the example in the regulations was "obscure and unconsidered" is likewise without foundation (Resp. Br. 42). The example in the regulation illustrated operation of a statutory provision aimed at exactly the situation now in issue—the fact that depreciation and amortization deductions offset ordinary income, while gain from sale of depreciable property may be taxed as capital gain. Both the Treasury and Congress were aware of this problem, for the Treasury had recently

[10] Pet. Br. 26-27, and notes 33 and 34.
[11] Pet. Br. 40, 47-48 and note 90; p. 3, *supra*.
[12] Pet. Br. 34-35 and note 54.

requested, and been refused, legislation to alter capital gain treatment on such sales (Pet. Br. 34-35). The example in the regulation and Congressional committee reports reflects the continued universal understanding that depreciation was allowable to the date of profitable sale. The many instances of alleged lack of "focus on the issue" are really reflections of the deeply embedded administrative practice.

The administrative, judicial and legislative precedents reflecting allowance of depreciation for the year of profitable sale do not suffer from the conflict or shortness of duration referred to in the exceptions cited by respondent to the enactment rule (Resp. Br. 44-46; see Pet. Br. 31-41). This is not a case of an isolated ruling, an occasional case, or an administrative practice not necessarily known to Congress, but a principle set forth in a series of rulings, reflected in a vast number of cases, expressly approved when placed in issue, acquiesced in by the Commissioner, and embodied in Congressional committee reports and Treasury regulations. Those numerous precedents evidence an administrative practice "long continued and substantially uniform in the Bureau and without challenge." *Higgins v. Commissioner*, 312 U. S. 212, 216 (1941).

III. The Commissioner Is Not Aided by His Argument That Section 1231 Does Not Conflict with His Interpretation.

We concur with the Commissioner's assertion that section 1231 deals only with how gain or loss on sale of a depreciable asset will be taxed (Resp. Br. 28-32), but we do not see how the assertion aids him. Our contention that a "reasonable allowance" for depreciation comprehends an allowance continuing to the date of sale is based on the language and the history of the interpretation of section 167. The Commissioner agrees that "[n]othing in the lan-

guage or history of [section 1231 and its predecessor] indicates any Congressional attempt to affect in any manner the orderly judicial elaboration of the phrase a 'reasonable allowance for' 'depreciation' in [s]ection 167" (Resp. Br. 29). As the Tax Court has stated:

> "We do not believe that the mere enactment of the predecessor of section 1231, which simply provided that gains on the sale or exchange of depreciable property held for more than six months would be considered as capital gains, also changed in any way the previously existing statutory scheme providing for (1) the depreciation of an asset up to the time of sale and (2) the taxation of any gain or loss realized upon the sale of such an asset, as a result of market conditions, pursuant to the applicable provisions relating to gain or loss." *Macabe Co.,* 42 T. C. 1105, 1117 (1964), on appeal to 9th Cir.

IV. The Commissioner Errs in Asserting That Commercial Accounting Principles are Irrelevant.

Recognizing that our position is squarely supported by business accounting principles, the Commissioner blandly dismisses those principles as irrelevant for income tax purposes (Resp. Br. 25-27). However, as even the Commissioner concedes, generally accepted accounting practices have been rejected in tax cases only "when they fail clearly to report income for tax purposes" (Resp. Br. 25).[13] In fairness he should have added, as he did in a recent ad-

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[13]None of the cases cited by the Commissioner involved the depreciation provision. *American Automobile Association* v. *United States,* 367 U. S. 687 (1961), involved the time of accrual of prepaid income; *Commissioner* v. *Hansen,* 360 U. S. 446 (1959) involved the time of accrual of automobile dealers' reserves; *Bazley* v. *Commissioner,* 331 U. S. 737 (1947), involved the definition of a reorganization; and *Brown* v. *Helvering,* 291 U. S. 193 (1934) involved the time of accrual of contingent liabilities.

dress, that the areas in which tax policy require a departure from commercial accounting are the exception, not the rule.[14] "Basically," said the Commissioner in that address, "the objective of both commercial and tax accounting is to establish procedures which will result in the proper determination of net income."

Unsurprisingly, the Commissioner's address—rather than his brief in this case—echoes the view of this Court. "Accounting for financial management and accounting for federal income tax purposes both focus on the need for an accurate determination of the net income from operations of a given business for a fiscal period." *Massey Motors, Inc.* v. *United States,* 364 U. S. 92, 106 (1960). In reaching a conclusion in *Massey* harmonious with that of commercial accounting, this Court cited writers in the nontax accounting field in support of that conclusion. *Ibid,* note 7.

The Commissioner attempts to drive a wedge between tax and commercial accounting for depreciation by mistakenly asserting that they seek to accomplish different purposes. (Resp. Br. 26-27.) Contrary to the Commissioner's assertion, commercial accounting—as well as tax accounting—limits depreciation to cost.[15] The basic depreciation

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[14]Address of Commissioner of Internal Revenue to American Institute of Certified Public Accountants at Dallas, Texas on September 20, 1965, reported in 22 Tax Barometer No. 43, ¶ 1722 (September 24, 1965).

[15]"Depreciation, from the accounting point of view, deals strictly with the question of the replacement of wasting assets at cost." Saliers, Depreciation Principles and Applications 69 (3d Ed. 1939). "In making an allowance for depreciation, the point of view of the accountant is backward toward original cost. . . ." I Dewing, The Financial Policy of Corporations 544 (5th Ed. 1953). "Depreciation is the gradual writing off of the cost of the fixed property of a business—the amortization of the original money cost of the asset—over successive income periods." *Id.* at 543. The "essential conception" of depreciation accounting "is that of assigning the cost of property to the accounting periods included in useful life." Paton, Accountants' Handbook 711 (3d Ed. 1944).

formula of the income tax regulations is identical with that of authorities on business accounting.[16]

The Commissioner misrepresents the function of financial accounting as that of "avoiding any overstatement of current net income from operations" (Resp. Br. 26). The suggestion that the financial accountant is free to understate but not to overstate net income is patently incorrect. The true function of financial accounting—as stated by this Court in the *Massey* case—is "accurate determination of the net income from operations." 364 U. S. at 106. That function—indeed, the essential purpose of both tax and financial accounting—with respect to depreciation is the making of "a meaningful allocation of the cost entailed in the use . . . of the asset to the periods to which it contributes." *Id.* at 104. That meaningful allocation requires an allowance for depreciation for the period of use of the asset during the year of sale, and a reduction of basis by such depreciation to obtain a fair reflection of gain on sale.

V. The Commissioner Errs in Asserting That Depreciation Should Be Measured by "Actual Net Cost."

The core of the Commissioner's brief is the contention that a taxpayer's depreciation deductions cannot exceed the "actual net cost" of the asset's use in the taxpayer's business (Resp. Br. 5, 6, 14, 17, 19, 22, 47). By comparing the taxpayer's January 1, 1957 adjusted basis ($326,628)

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[16] *Compare* Treas. Reg. § 1.167(a)-1(a) and (c) *with* the following:

"*Depreciation accounting* is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit . . . in a systematic and rational manner." American Inst. of Accountants, Committee on Terminology, Terminology Bulletin No. 1, p. 25 (1953). "The factors necessary to the computation of the current accounting period's depreciation charge are (a) original cost, (b) estimated life, and (c) estimated salvage value." Saliers, *op. cit. supra* 160.

with the December, 1957 sale price ($695,000), the Commissioner concludes that the taxpayer had no "actual net cost" for the use of the *Feuer* during 1957. The taxpayer knew "its use of the ship during 1957 had cost it nothing" (Resp. Br. 2, 4, 10, 19, 24, 46).

Despite its beguiling simplicity, the Commissioner's argument is utterly fallacious. The conclusion that use of the *Feuer* during 1957 cost the taxpayer nothing is based not on "actual facts," as the Commissioner asserts (Resp. Br. 5, 16, 19), but on wholly arbitrary assumptions as to the manner in which the cost of the *Feuer* should be allocated against the income produced by it. The *Feuer*, having suffered wear, tear and obsolescence during 1957, was not the same asset in December as in January of that year. The Commissioner ignores this fact, however, and applies the entire adjusted basis of the *Feuer* as of January 1, 1957 against the sales price of the more consumed asset sold in December, 1957. This mismatching of the cost of the less consumed asset against the sales price received almost a year later for the more consumed asset distorts both the gain realized on sale of the *Feuer* and the income produced from its consumption during 1957.

The mismatching of the cost of the less used asset against the sales price of the more used asset directly violates the principles of *United States* v. *Ludey, supra,* p. 5. "When the plant is disposed after years of use, the thing then sold is not the whole thing originally acquired." The "cost of that disposed of in the final sale" is less than the "original cost of the whole"; the difference is the cost of what has been consumed through use. See 274 U. S. at 301. By the same token, an exhaustible asset sold at the end of a given year is not the "whole thing" existing at the beginning of the year. A portion of the asset has been consumed during the year. The arbitrary lumping of the cost of the whole against the price received for a part—thus denying any al-

location to the income produced by the part consumed during the year—is a distorted method of cost allocation.

The distortion may readily be seen in the case of a taxpayer who purchases for $100,000 a royalty-producing patent that will expire in five years and resells it at the end of the fourth year. Under the straight-line method of depreciation, the taxpayer would write off $80,000 against the four years of royalty income received by him and the remaining $20,000 against the sales price (representing the value of his right to the fifth year's royalties.)[17] If the royalty yield has reached $40,000 a year, he will have net income of $20,000 for the fourth year and a profit on sale of about the same amount. However, under the Commissioner's approach the right to the fifth year's royalties cost the taxpayer $40,000 and the fourth year's royalties cost him nothing.

Similarly, if a taxpayer buys land with timber upon it for $10,000, cuts down the timber, and later sells the land for $11,000, his gain on the sale cannot properly be computed without reference to the cutting of the timber.[18] The total cost should be allocated between land and timber on the basis of the facts existing at the time of purchase, and the portion of the cost allocable to the timber written off as depletion deductions as the timber is cut. If one-third of the timber is cut in each of two years and the land is sold at the end of the second year with one-third of the timber still standing, one-third of the cost of the timber should be deducted for the second year, and one-third of its cost should enter into the computation of gain on the sale. However, the Commisisoner's theory would lead to the absurd conclusions that two-thirds of the timber cost should be allo-

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[17]Since a patent—like a copyright or a leasehold—has no salvage value, its entire cost is written off over its useful life. Treas. Reg. §§ 1.167(a)-4 and 1.167(a)-6(a).

[18]The Board of Tax Appeals used this example in its decision in *Even Realty Co., supra* pp. 8-9, at 358.

cated to the one-third sold and that the one-third of the timber cut in the second year cost the taxpayer nothing.

To protect the cost allocation process the regulations define "useful life" and "salvage value" as factors to be determined at the time of acquisition of the property.[19] The prohibition in the regulations against changing estimated salvage value to reflect changes in price levels is not a mere administrative convenience, as the Commissioner contends (Resp. Br. 14, 18); instead, the prohibition is basic to the cost allocation concept. The regulations reflect the fundamental principle that changes in price levels should not disturb the process of cost allocation involved in depreciation, a principle that applies whether or not the change in price level is realized through sale.[20]

The Commissioner attempts to support his theory by reading the regulations as though they read "actual sales price" wherever they actually speak of "salvage value" as defined in section 1.167(a)-1(c). By the same type of unwarranted substitution he misreads what this Court said in validating the regulations in the *Massey* and *Hertz* cases. Every reference to salvage value in the regulations and in the *Massey* and *Hertz* cases is in terms of estimates; yet the Commissioner cites them throughout as though they spoke of "actual sales price" and thus validated his "actual net cost" theory (Resp. Br. 17, 19, 22, 23).

To discard useful life and salvage value as defined in the regulations in favor of the actual period of use and sales price when the latter become known would destroy the framework of the cost allocation process. By that process the cost of the portion of the property consumed in business operations is separated from the cost of the portion disposed of on sale. The regulations do not mysteriously neglect to

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[19]Treas. Reg. § 1.167(a)-1(b) and (c).

[20]*Even Realty Co., supra* pp. 8-9, at 361; *Max Eichenberg*, 16 B. T. A. 1368, 1370 (1929); *Whitelite Electric Co.*, 18 B. T. A. 934, 936 (1930); *Wier Long Leaf Lumber Co., supra* note 4, p. 9.

deal with the event of sale; instead, they refrain from supplanting salvage value as defined in section 1.167(a)-1(c) because that would destroy the only conceivable way of fairly separating depreciation from capital gain.

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November 8, 1965

APPENDIX

	Decision or ruling	Date of profitable sale	Type of property	Tax classification of gain	Relevant allowance for year of sale
1.	Eldorado Coal & Mining Co. v. Mager, 255 U.S. 522, 526 (1921)	May, 1917	Coal mine and mining plant	Ordinary	Depreciation and depletion to the date of sale subtracted to determine basis for gain on sale.
2.	I.T. 1494, I-2 Cum. Bull. 19 (1922)	1917	Unstated	Ordinary	Property depreciated to date of sale, to $40,000, in the year of its sale for $47,000.
3.	Grosvenor Atterbury, 1 B.T.A. 169, 170 (1924)	June 17, 1920	Leasehold	Ordinary	$2,970.51 depreciation allowed for 5-17/30 months of 1920 to date of sale.
4.	William Ziegler, Jr., 1 B.T.A. 186, 192 (1924)	July 1, 1919	Buildings	Ordinary	Commissioner computed depreciation at 2% rate to date of sale.
5.	S.M. 2112, III-2 Cum. Bull. 22 (1924)	May, 1919	Leasehold	Ordinary	Deduction authorized for exhaustion of the lease due to lapse of time.
6.	Even Realty Co., 1 B.T.A. 355, 356 (1925)	1920	Office building	Ordinary	Depreciation allowed to date of sale at rate of 2% per annum.
7.	W. W. Carter Co., 1 B.T.A. 849, 851 (1925)	January 30, 1920	Leasehold	Ordinary	Deduction for exhaustion of lease computed to date of sale.
8.	Marchetti Roma Cafe Co., 2 B.T.A. 529, 530 (1925)	December 3, 1921	Restaurant equipment	Ordinary	Depreciation claimed and allowed for year of sale.
9.	Emily N. Vanderpoel Trust, 3 B.T.A. 372, 373-374 (1926)	May 1, 1920	Building	Ordinary	Depreciation computed at rate of 3% per annum to determine basis for gain on sale.
10.	Capital City Investment Co., 4 B.T.A. 933, 935 (1926)	May 28, 1919	Leasehold	Ordinary	Deduction for exhaustion of lease computed to date of sale.
11.	United States v. Ludey, 274 U.S. 295 (1927)	February, 1917	Oil leases and production equipment	Ordinary	Depreciation and depletion allowed to date of sale. (Pet. Br. 19-20.)
12.	G.C.M. 1597, VI-1 Cum. Bull. 71 (1927)	1926	Improved real estate	Capital	Depreciation for the portion of the year 1926 up to the date of sale subtracted to determine basis of property.
13.	Duncan-Homer Realty Co., 6 B.T.A. 730, 731-732 (1927)	1923	Improved real property	Ordinary	Board of Tax Appeals ruled that the taxpayer had the right to deduct depreciation for the year of sale.

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14.	Louis Kalb, 15 B.T.A. 865, 866 (1929)	1920	Buildings	Ordinary	Depreciation allowed at rate of 4% per annum to date of sale.
15.	Max Eichenberg, 15 B.T.A. 1368, 1369 (1929)	1922	Building	Capital	Depreciation claimed and allowed for year of sale.
16.	United States v. Farrell, 35 F.2d 38, 39 (D. Conn. 1929)	November 25, 1919	Manufacturing plant	Ordinary	$4,608.80 depreciation claimed and allowed for year of sale.
17.	Franklin Lumber & Power Co., 18 B.T.A. 1207, 1211 (1930), rev'd on other grounds, 50 F.2d 1059 (4th Cir. 1931)	1923	Manufacturing plant	Ordinary	Depreciation claimed and allowed for year of sale.
18.	Herbert Simons, 19 B.T.A. 711, 712-713 (1930)	October 11, 1924	Apartment house	Capital	Commissioner required deduction of depreciation for year of sale and Board of Tax Appeals approved.
19.	Seymour Manufacturing Co. v. Burnet, 56 F.2d 494, 495-496 (D.C. Cir. 1932)	July, 1923	Manufacturing plant	Ordinary	Commissioner computed depreciation for entire period of ownership to date of sale.
20.	Barnett Anchor Oil Co., 25 B.T.A. 746, 749 (1932)	1925	Oil lease	Ordinary	$25,658.79 depletion allowed for year of sale.
21.	C. E. Wentz, Trustee, 26 B.T.A. 868, 869 (1932)	July 28, 1924	Oil and gas leases	Capital	Depletion claimed and allowed for year of sale.
22.	M. Hilty Lumber Co. v. United States, 3 F. Supp. 657, 658 (Ct. Cl. 1933)	May 1, 1919	Sawmill and standing timber	Ordinary	Depletion and depreciation claimed and allowed to date of sale.
23.	C. B. Shaffer, 29 B.T.A. 1315, 1323-1325 (1934)	May 31, 1919	Oil and gas leases	Ordinary	Commissioner conceded that depreciation for January 1 to May 31, 1919 was allowable.
24.	George Blodgett Co. v. Ham, 16 A.F.T.R. 1003 (D. Me. 1934)	1929	Manufacturing plant	Ordinary	Depreciation claimed and allowed for year of sale.
25.	Clark Thread Co., 28 B.T.A. 1128, 1140, 1150-51 (1933), aff'd, 100 F.2d 257 (3d Cir. 1938)	1923	Buildings and machinery	Ordinary	Depreciation allowed for year of sale.
26.	Nocona Cotton Seed Oil Co., 42 B.T.A. 1172, 1175, 1178 (1940)	October 5, 1937	Manufacturing plant	Ordinary	$715.36 of depreciation allowed for year of sale.
27.	Hall v. United States, 43 F. Supp. 130, 131-132 (Ct. Cl.), cert. denied, 316 U. S. 664 (1942)	June 8, 1932	Leaseholds	Capital	Depreciation allowed at rate of 2% per annum to date of sale.

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28.	Gunnison Sugar Co. v. Hinckley, 32 A.F.T.R. 1666, 1668 (D. Utah 1942), rev'd, 139 F.2d 492 (10th Cir. 1943)	June 21, 1940	Sugar refinery	Ordinary	Depreciation claimed and allowed for year of sale.
29.	Elizabeth Operating Corp., T. C. Memo. 112709, 2 CCH T. C. Memo. 817, 818 (1943)	January 15, 1940	Hotel	Ordinary	Depreciation claimed and allowed for the first 15 days of 1940 at rate used in prior years.
30.	F. A. Gillespie & Sons Co. v. Commissioner, 154 F.2d 913, 914-915 (10th Cir. 1946)	June 15, 1937	Oil and gas leases	Ordinary	Depreciation and depletion claimed and allowed for year of sale.
31.	Crane v. Commissioner, 331 U.S. 1 (1947)	November 29, 1938	Apartment building	Ordinary	$3,200 of depreciation claimed and allowed for year of sale (3 T.C. 585, 587).
32.	Wier Long Leaf Lumber Co., 9 T.C. 990, 999 (1947), aff'd and rev'd on other issues, 173 F.2d 549 (5th Cir. 1949)	1942	Automobiles	Capital	Tax Court held depreciation was allowable for year of profitable sale.
33.	P. H. & J. M. Brown Co., T.C. Memo. 1959-162, 18 CCH T. C. Memo. 708, 709-710 (1959)	July 1, 1949	Leasehold and improvement	Capital	Depreciation at rate of 2% per annum claimed and allowed to date of sale.
34.	H. L. Gatlin, T. C. Memo. 1960-23, 19 CCH T. C. Memo. 131, 132 (1960)	1953	Livestock	Capital	$505 depreciation allowed for year of sale at profit of $1,035.28.
35.	Massey Motors, Inc. v. United States, 364 U.S. 92 (1960)	1950	Automobiles	Capital	Automobiles depreciated to $1,325 in year of sale for an average of $1,380 (Pet. Br. 21.)
36.	Hertz Corporation v. United States, 364 U.S. 122 (1960)	1954-1956	Automobiles	Capital	Depreciation deducted and allowed for year of profitable sale (Pet. Br. 21-22.)